

OFFICE OF LEGISLATIVE RESEARCH
PUBLIC ACT SUMMARY



PA 14-2—sHB 5465

Finance, Revenue and Bonding Committee

**AN ACT CONCERNING THE CONNECTICUT AEROSPACE
REINVESTMENT ACT**

SUMMARY: This act allows large manufacturers to redeem unused corporation business tax credits earned for researching and developing (R&D) new products and production techniques. But, a manufacturer may not be able to use these and the other credits the law provides if they are, for example, worth more than the amount of taxes a manufacturer owes (see BACKGROUND).

Under the act, a manufacturer may redeem unused R&D credits if, among other things, it employs at least 15,000 people in Connecticut and undertakes a minimum \$100 million industrial reinvestment project (IRP), which may include one or more activities ranging from constructing plants to training employees. The redemption may be (1) an offset or refund for corporation business or sales and use taxes or (2) another form of compensation the Department of Economic and Community Development (DECD) commissioner chooses to provide.

The act specifies the process for redeeming the credits. A manufacturer must submit a proposed IRP to the commissioner for certification. If she certifies the IRP, the manufacturer and the commissioner must enter into a reinvestment contract that specifies how the state will redeem the credits and the terms and conditions under which it will do so. The commissioner's authority to enter into these contracts ends June 30, 2015.

The act also specifies how the commissioner must calculate annual redemption amounts, which are subject to various caps. During the redemption period, the manufacturer cannot earn new R&D credits or exchange unredeemed credits for cash, as existing law allows.

The commissioner must (1) identify other methods for redeeming credits that help businesses grow and create or retain jobs in Connecticut and (2) if appropriate, propose authorizing legislation. The commissioner also must report on approved IRPs in her comprehensive annual report to the governor and legislature.

Lastly, the act makes many technical changes.
EFFECTIVE DATE: Upon passage

R&D TAX CREDITS

By law, manufacturers can earn tax credits against the corporation business tax for R&D expenditures that are deductible from federal business taxes. A statutory formula determines the maximum amount of credits the manufacturer may claim against its state corporation business taxes (see BACKGROUND).

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Other statutory provisions cap the amount the manufacturer may claim each year, but also allow it to carry forward and claim in subsequent tax years any unused credits (CGS § 12-217n). The act allows manufacturers to redeem these unused credits instead of carrying them forward and claiming them in subsequent years.

ELIGIBILITY

Eligible Manufacturers

The DECD commissioner may redeem unused R&D tax credits earned by individual manufacturers or groups of manufacturers filing combined corporation business tax returns if they:

1. are in a federally defined industrial sector (sectors 31-33, as defined in the federal Office of Management and Budget's *North American Industrial Classification System*, 2012 edition);
2. employ at least 15,000 people in Connecticut;
3. spent at least \$200 million per year on federally tax deductible R&D in Connecticut during the five full income years immediately preceding the application for IRP certification (see below); and
4. accumulated at least \$400 million in unused R&D credits.

Eligible IRPs

The commissioner may redeem an eligible manufacturer's unused R&D credits if the manufacturer proposes to spend at least \$100 million in Connecticut on:

1. buildings, improvements, property, plants, and equipment (physical development);
2. design work, professional fees, surveys and site preparation, remediation and cleanup, demolition, moving and renovation expenses, and other activities directly related to the physical development activities;
3. personal property;
4. federally tax-deductible R&D; and
5. employee hiring and training.

The manufacturer must incur these IRP-eligible expenditures within five "exchange years," the period during which the manufacturer is eligible for credit redemption. The first year begins on the date specified in the reinvestment contract (see below) and ends on June 30, 2015. Each successive contract runs from July 1 to June 30. The commissioner must begin redeeming a manufacturer's unused credits in exchange for implementing an IRP no sooner than July 1, 2015.

IRP APPROVAL PROCESS

IRP Certification

Manufacturers seeking to redeem unused R&D credits must propose an IRP to the commissioner for certification as meeting the act's criteria. A manufacturer must request the certification on a form she accepts, providing the information she

requires. At a minimum, the manufacturer must:

1. provide a detailed plan outlining the IRP,
2. indicate how long it will take to complete it,
3. estimate the IRP's costs, and
4. specify the amount of unused credits the taxpayer proposes for redemption.

The commissioner may require any additional information needed to evaluate the request. The revenue services commissioner must confirm the amount of unused credits the DECD commissioner approves for redemption.

Only the DECD commissioner may decide whether to certify a proposed IRP, and the manufacturer cannot construe this requirement as a waiver of the state's sovereign immunity or an authorization for the manufacturer to sue the state if the commissioner denies certification.

Reinvestment Contract

Content. The vehicle for redeeming the credits is the reinvestment contract between the DECD commissioner and the manufacturer. The contract, which the commissioner may execute after certifying the proposed IRP, must specify:

1. each IRP segment;
2. the timeframe for completing the IRP;
3. the total amount of eligible expenditures the manufacturer agrees to make to complete the IRP;
4. the base levels for calculating credit redemption payments for projects seeking over \$200 million in such payments (see below);
5. the amount of the credit redemption payment, determined by the act's formula;
6. the terms and conditions the manufacturer must satisfy to receive these payments, including information it must submit to the commissioner and provisions (a) giving her access to the relevant records and (b) allowing her to verify their accuracy;
7. a requirement that the manufacturer repay the redeemed credits if it fails to comply with the contract;
8. how the manufacturer must notify the commissioner about disputed claims under the contract; and
9. any other terms and conditions the commissioner chooses to impose.

The act exempts the contract from specific laws imposing requirements that are inconsistent with the contract's provisions. These requirements:

1. limit the extent to which credits can be used to reduce a business' tax liability,
2. specify how R&D credits must be calculated,
3. list the order in which credits earned for different purposes may be claimed,
4. limit the amount of economic development funds a project may receive based on its location, and
5. require legislative approval for such projects if the funding exceeds specified thresholds.

Resolving Disputes. If a manufacturer cannot resolve any claims under the contract, it may sue the state in Hartford Superior Court. The manufacturer must first notify the commissioner, as the contract requires. It must also bring the action within two years of this notice. The act reserves all legal defenses to the state except sovereign immunity.

CREDIT REDEMPTION

Redemption Forms

Manufacturers may redeem only those unused R&D credits they accumulated up to the end of the last income year before submitting an IRP for certification, and the commissioner may determine how and when they may redeem them. She may provide (1) corporation business or sales and use tax refunds or offsets or (2) grants, loans, or other forms of financial assistance. She must consult with the revenue services commissioner if she chooses to redeem the credits with tax refunds or offsets.

Credit Redemption Amount Caps

The act caps the amount of redemption the commissioner may provide. It caps the total amount of redemption available for all eligible manufacturers at \$400 million and further caps the amount available each year at (1) \$20 million per year during the first five years she redeems credits under a reinvestment contract and (2) \$33,334,000 per year for the nine subsequent payment years under that contract.

The act also caps the total amount of credits a manufacturer can redeem for undertaking a certified IRP at the total amount of eligible expenditures. The actual cap varies depending on the redemption amount. If that amount exceeds \$200 million (large IRPs), the redemption cap equals the total value of eligible IRP expenditures or \$375 million, whichever is less. If the redemption amount equals no more than \$50 million (small IRPs), the cap is the total value of eligible IRP expenditure or \$50 million, whichever is less.

The manufacturer cannot make any use of the credits the commissioner approves for redemption, but it may use those she did not approve for this purpose as the law allows.

The DECD commissioner must notify the revenue services commissioner about the value of the credits she approves for redemption under a reinvestment contract.

Calculating Actual Redemption Amount for Large IRPs

The method for calculating redemption amounts depends on the IRP's size. For a large IRP or a segment of it (up to the \$375 million cap mentioned above), the redemption amount in each of the first five "payment years" equals a portion of the eligible expenditures incurred during each of those years. That portion is based on the level of the manufacturer's annual activity in four areas—engineers employed in Connecticut, total Connecticut workforce, total Connecticut payroll, and total R&D and capital expenditures (excluding such expenditures made under

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the reinvestment contract).

The act assigns a maximum percentage weight to each of these areas, the total of which equals 100%. The act provides a schedule specifying activity levels for each area and a corresponding percentage weight. The manufacturer must select the level that matches its activity level for its most recently completed fiscal year prior to the year the commissioner certified the IRP (base level). The actual weight for each area depends on the degree to which the activity fell above or below the designated base level. The commissioner determines the redemption amount by totaling the actual weights for each area and multiplying the sum by the total eligible IRP expenditures.

The manufacturer must specify the base level for each area in the reinvestment contract and certify those levels within 120 days after entering into that contract. If the manufacturer certifies base levels that are different from those in the contract, the commissioner may adjust the weighting factors specified in the act, but the act does not specify how she must do so.

Table 1 shows the factors the commissioner must use to calculate the redemption amounts for a hypothetical IRP. It identifies the weighting factors, the maximum percentage weight for each factor, base level the manufacturer certified in the reinvestment contract, and range of weighting percentages for selected activity levels above and below that level.

Table 1: Weighting Factors for Calculating Hypothetical Large IRP Redemption Amount

<i>Performance Factor Components</i>	<i>Performance Factors</i>			
	<i>Employment Level of Engineers in Connecticut</i>	<i>Overall Connecticut Employment Level</i>	<i>Connecticut Payroll Levels</i>	<i>R&D and Capital Expenditure Levels</i>
Maximum Weighting Percentage	20%	30%	30%	20%
Performance Levels	4,350-5,000 engineers	12,450-14,400 employees	\$1.370 million - \$1.565 million payroll	\$680.0 million - \$810.0 million R&D and Capital Expenditures
Range of Activity Levels and Associated Weighting Percentages	Below 4,350: 0%	Below 12,450: 0%	Below \$1.370 million: 0%	Below \$680.0 million: 0%
	4,900 base level: 18%	14,100 base level: 27%	\$1.535 million base level: 27%	\$790.0 million base level: 18%
	5,000: 20%	14,400: 30%	\$1.565 million: 30%	\$810.0 million: 20%

As noted above, the commissioner determines the annual redemption amount by multiplying the eligible expenditure for a payment year by the sum of the percentages for each weighting factor. Table 2 shows how the commissioner would calculate the annual redemption amount for the hypothetical IRP.

Table 2: Calculating Redemption Amount for Hypothetical IRP

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Step 1: Determine Annual Eligible IRP Expenditures: Given: Annual Eligible IRP Expenditures Equals \$50 million					
Step 2: Determine Total Annual Weighting Factors					
Variables	Weighting Factors				
	Employment Level of Engineers in Connecticut	Overall Connecticut Employment Level	Connecticut Payroll Levels	R&D and Capital Expenditure Levels	Total Actual Weight
Base Activity Level	4,900 engineers	14,100 employees	\$1,535 million	\$790.0 million	
Actual Activity Level	5,000 engineers	14,100 employees	\$1,535 million	\$810.0 million	
Actual Weight	20% (out of 20%)	27% (out of 30%)	27% (out of 30%)	20% (out of 20%)	94% (out of 100%)
Step 3: Determine Redemption Amount \$50 million (Annual IRP Eligible Expenditures) X 94% (Total of Weighting Factors) = \$47 million (Redemption Amount)					

Calculating Credit Exchange Payments for Small IRPs

The method for calculating redemption amounts for small IRPs is based on their R&D and capital expenditures components. The R&D component consists of (1) actual R&D expenditures and (2) the number of people the manufacturer retained to conduct R&D in Connecticut during that payment year.

Table 3 shows the required spending and employment retention levels for each component.

Table 3: Schedule for Calculating Redemption Amounts for Small IRPs

Component	Minimum Requirement	Credit Exchange Payment Amount
Capital Component	Over \$1 million per component	40% of the total expenditure for each component over \$1 million
R&D Component	Over \$10 million for all components and retain at least 100 employees in Connecticut	\$1 million per component

RESTRICTIONS ON EARNING NEW CREDITS OR EXCHANGING UNUSED CREDITS DURING EXCLUSION PERIOD

After the commissioner approves a manufacturer for credit redemption, the manufacturer cannot earn new R&D credits nor qualify for cash refunds for unused credits during the “exclusion period,” which must be specified in the reinvestment contract. This ban applies to the 20% incremental and rolling R&D credits (CGS §§ 12-217j and 12-217n, respectively) (see BACKGROUND). But the manufacturer may still claim any accumulated incremental R&D credits and

any accumulated but unredeemed rolling R&D credits. The act does not stop the manufacturer from using other already approved credits or affect its eligibility for these credits.

LEGISLATIVE REPORT

The DECD commissioner must report on the credit redemption amounts in her comprehensive annual report to the governor and legislature. In doing so, she must include the number of projects she approved and reinvestment contracts she executed, status of each certified IRP, amount of credits redeemed, and performance levels the manufacturers achieved to obtain the payment amounts.

BACKGROUND

R&D Tax Credit

The law authorizes two types of R&D tax credits businesses may claim against the state's corporation business tax. It authorizes a credit equal to 20% of the annual increase in R&D expenditures over the prior year (incremental R&D credit; CGS § 12-217j) and a credit based on a manufacturer's size, location, and total annual R&D expenditures (rolling R&D credit; CGS § 12-217n). Regarding the latter, the credit equals the greater of: (1) 3.5% of a manufacturer's annual R&D expenditures or (2) the amount derived using a two-step formula for calculating credit amounts. Applying the formula, the manufacturer first calculates the tentative credit amount, based on its total R&D expenditure for the year. The amount ranges from 1% of R&D expenditures totaling less than \$50 million to \$5.5 million plus 6% of R&D expenditures above \$200 million.

The second step limits the actual amount of credit the manufacturer may claim to the greater of the following amounts:

1. 50% of the tax liability without subtracting the R&D credit or
2. the lesser of (a) 200% of the total tentative credit amount, as determined in the first step, or (b) 90% of the total tax bill, without subtracting the R&D credit.

The credit for manufacturers that do not meet the location, size, and annual revenue criteria equals the amount derived from applying the two-step formula.

Accumulating Unused R&D Tax Credits

Businesses accumulate unused credits when the credit amounts exceed their tax liability or the credit cannot be (1) transferred or assigned to another taxpayer or (2) carried forward or backward for application against future or past tax liability. Other factors that might cause a manufacturer to accumulate credits are the laws barring them from using credits to reduce their annual tax liability by more than 70% (CGS § 12-217zz) and specifying the order in which they may claim credits (CGS § 12-217aa).

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